A•F•G•I

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Unconditional, Irrevocable Guaranty®

June 18, 2007

Mr. Lawrence Smith, Director
Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7, P.O. Box 5116
Norwalk, CT 06856-5116

LETTER OF COMMENT NO. 39

File Reference No. 1530-100

Dear Mr. Smith:

This letter is submitted on behalf of the Association of Financial Guaranty Insurers ("AFGI" or "we") in response to the Financial Accounting Standards Board's ("FASB" or the "Board") Exposure Draft *Accounting for Financial Guarantee Insurance Contracts* (the "ED"). AFGI is the trade association of the insurers and reinsurers of municipal bonds and asset-backed securities. In a traditional financial guaranty transaction, the insurer guarantees scheduled payments on a bond or other debt security in exchange for payment of an insurance premium. Use of the guaranty generally attaches the insurer's credit rating to the insured obligation, allowing the insured obligation to bear a lower interest rate than it would otherwise require. Members of AFGI who participated in the preparation of this comment letter represent the firms that would be subject to the accounting guidance of the proposed Statement. Our objective in this letter is to highlight what we regard as the most important issues. Many individual member companies will also be submitting separate letters of comment, which will address the numbered issues included in the ED. Representatives of AFGI member companies would very much like to participate in the planned round table meeting scheduled for July 16.

Scope:

We believe that the provisions of the ED that address claim liability (loss) recognition can be put into practice, and will improve financial reporting by reducing diversity across the industry. That proposed guidance is responsive to the concerns that led the Board to undertake this project. We believe that a new standard that is limited to the provisions concerning claim liability could reasonably be issued and implemented on a schedule consistent with the proposed effective date subject to resolving our interpretational concerns discussed below in the Claim Liability Methodology section.

While we understand the Board's view that a loss recognition model is appropriately selected in the context of the revenue recognition model, we would ask the Board to consider issuing a standard limited to claims liability recognition as proposed. The provisions of the ED that address revenue recognition and balance sheet reporting introduce serious conceptual and practical operational concerns which are set forth below. We note that there is no significant diversity in current practice in these areas and that

139 Lancaster Street • Albany, NY 12210-1903 • Phone 518.449.4698 • Fax 518.432.5651

ACA Financial Guaranty Corporation • Ambac Assurance Corporation • Assured Guaranty Corp. • BluePoint Re Limited • CIFG • Financial Guaranty Insurance Company
Financial Security Assurance Inc. • MBIA Insurance Corporation • Radian Asset Assurance Inc. • RAM Reinsurance Company Ltd. • XL Capital Assurance Inc.

current practice is well understood by the principal users of our financial statements, including analysts, the rating agencies and the investor community. We believe that the proposed loss recognition model is compatible with the current revenue recognition model and could be implemented as an improvement in financial reporting without adopting a new revenue recognition model.

We also note that the International Accounting Standards Board ("IASB") has issued a discussion paper as part of its project that would propose a significant new accounting model for all insurance companies, and that the FASB intends to pursue a parallel project. The IASB projects that a new standard might be in place by 2010. We believe that it would be a disservice to our investors and to users of our financial statements to require a new accounting model as proposed in the ED when another significant change may be on the horizon and no urgent critical deficiency has been identified with current practice. The costs of making such a model change, including the costs for companies to modify systems and for users of financial statements to understand the new information, are significant. We do not believe it would be cost beneficial to implement the proposed revenue recognition and balance sheet changes, especially if further costs may be incurred to implement an entirely new insurance accounting model should the IASB project move forward. We urge the Board to defer consideration of the revenue recognition and balance sheet reporting issues.

Given that the proposed standard cannot be applied or analogized to similar products issued by entities other than monoline financial guarantors, we also suggest that the Board consider incorporating into the proposed standard the application of other accounting standards (e.g., Statements 155 and 133 and Interpretation 46R) to Financial Guarantee contracts ("FG contracts"). Current application of these accounting standards results in different accounting treatment (i.e., mark to market, consolidation, or insurance) for contracts with essentially the same economic substance. We believe the development of a standard specifically for the financial guarantors provides a significant opportunity to provide uniform accounting treatment for similar risks which will reduce complexity and increase the transparency of financial reporting for users of the financial statements.

Revenue Recognition:

The ED proposes to recognize premium revenue for FG contracts only as payments are made on the guaranteed obligation, with no recognition attributed to the passage of time. We understand that the Board views the payment of debt service as the best indicator of when the risk to the insurance enterprise is reduced. In our view, the proposed approach lacks representational faithfulness. We believe a revenue recognition model based on the service provided to the policyholder is more appropriate. Under an FG contract, the beneficiary of a policy is protected for an economic loss throughout the term of the security. Accordingly, an insurance enterprise should recognize revenue as this protection (service) is provided.

Further, under an FG contract, the risk is reduced as time passes without an adverse event affecting the debtor. Each day or month that passes without occurrence of an adverse or insured event is the expiration of some of the risk assumed by the insurance enterprise, a concept referred to as "risk amortization". A credit default generally is an indirect result of

some adverse event(s) affecting the debtor which impairs the debtor's ability to satisfy its obligations when due.

Risk amortization is evident in the cumulative default probability tables published by the rating agencies. Those tables demonstrate the positive correlation between risk reduction and time passage, i.e., the risk of default reduces as time passes. This relationship is fundamental to the market pricing of FG contracts, i.e., premium revenues increase as a function of time. For example, a 10-year risk will command less aggregate premium than a 30-year risk, assuming the same issuer and all other things are equal.

We also believe the concept of time passage is a component of the short and long-duration insurance contract models of Statement 60. Premiums for long duration contracts (typically level during the contract term) are generally recognized when due, and premiums for short duration contracts are generally recognized evenly over the contract period. The concept of time passage is also a component of the current accounting model for financial instruments. In the case of a non-insured bond for example, a portion of the investment income an investor earns on the bond represents compensation for the investor's exposure to the bond issuer's credit. Unlike the proposed accounting for FG contracts, however, the investor in a bond is not required to defer revenue recognition until the principal and accrued interest are received at maturity. We believe that the proposed approach would be a significant departure from these established models. Exhibit 1 is an analysis, based on actual bonds, of how the accounting under the ED would differ from that of the bearer of credit risk in an uninsured bond. Exhibit 2 is an illustration of how the accounting for unearned premium reserve under the ED would differ from current practice, for three assumed municipal bonds where the premium is collected upfront, compared with the amortization of default risk.

If the Board decides to proceed with a new standard for premium revenue recognition, we recommend a level yield approach based on the average principal balance of the insured obligation outstanding for the period. This methodology would achieve consistent treatment of revenue whether a premium is paid up-front or on an installment basis over the life of a contract and would result in a constant premium to average principal balance guaranteed. It also is consistent with the view of risk in the industry, which suggests that the marginal annual risk insured is nearly constant over the life of the transaction. We note that a level yield revenue recognition model would not depend on estimates of prepayments for asset-backed securities with installment premiums and it automatically corrects for prepayments which may be faster or slower than originally expected.

Receivable for Future Premiums:

For an FG contract issued with an installment premium, the ED proposes to base the measurement of both premiums receivable and unearned premium revenue on the maximum contractual amounts under the FG contract, with no consideration of expectations that the life of the FG contract may be shorter, for example because of prepayments of the underlying mortgages securitized in a mortgage backed security. The expected lives of the insured obligations can be readily estimated. Information about the estimated lives of these insured obligations is available and is used for other purposes. The market prices of the insured instruments are clearly based on expected lives.

There are many FG contracts issued on obligations for which the expectations of all parties are that the obligations will be paid sooner than the maximum contractual maturity because of prepayments received on the underlying assets throughout the life of the obligation or for other reasons (for example, contractual provisions in the underlying debt obligations that provide an incentive to refinance). Specifically, mortgage backed and other asset backed securities generally have this characteristic. Since the amount of insurance needed ("level of service") in any given period is uncertain, these policies generally have premiums payable each period, which align the insurance enterprise's revenue and the counterparty's cost with the risk assumed and the protection provided. For such policies, the ED proposes to recognize a premium receivable for the present value of the hypothetical premiums that would be received if the underlying obligations remained outstanding for their maximum contractual term. Although there is uncertainty as to the exact amount of prepayments of the underlying obligation, by requiring the use of maximum contractual terms, the Board is in effect assuming that the rate of prepayment will be zero, which based on experience, is a very unrealistic assumption.

We understand the Board's view that an asset and a liability are created when an FG contract is issued with an installment premium, but we believe strong arguments exist for not recording an asset and a liability for these executory contracts, including consistency with Statement 60. If the Board decides to proceed with a standard for recognition of those amounts, we believe it is essential that expected lives be considered in the measurement. If estimates of expected life are not permitted, it is possible that the premium receivable asset could be deemed to be impaired on the day it is initially recognized. While we understand and support the Board's decision not to pursue a fair value model in this project, it is troublesome to us that the amount of the asset recorded under the ED would often be a multiple of the asset's day one economic value. The proposed approach is inconsistent with APB Opinion 21, paragraph 12. In addition, we believe the standard as written (par. 11) may require the inevitable adjustments as prepayments occur to be charged to bad debt expense. Since the prepayment does not involve any party defaulting on any obligation, we believe that would mischaracterize the adjustment and confuse users of the financial statements.

Bifurcation of Revenues between Premium and Investment Income:

The ED would require that accretion on the discounted measure of an installment receivable be reported separately as investment income. While we understand the argument that there is an element of financing in any deferred payment, we believe it would be more appropriate to argue that there is an element of financing provided *to the insurance enterprise* when a single premium payment is made up front for several periods of coverage. The typical installment premium is being paid from cash flows generated by the assets supporting the insured obligations and is paid as the service (insurance) is received. In our view this should not be viewed as financing. Collection of premiums on an installment basis is a market standard for contracts of this type, not a choice made by the issuer of the FG contract, primarily because it avoids the negotiation of expected prepayment rates necessary to derive an upfront premium amount. We also believe that the proposed bifurcation is inconsistent with other provisions included in the Statement 60 insurance accounting model, and would fundamentally change the concept of premiums

written. We would alternatively recommend that the time element of the installment premium receivable be accreted as premium revenue.

Claim Liability Methodology:

The ED would require measurement of the "expected cash flows" of claim liabilities, defined as the probability-weighted expected net cash flows that reflect the likelihood of all possible outcomes. While we believe as noted above that those provisions of the ED can be put into practice, we do have two concerns with their interpretation. First, we interpret the measurement provisions of the ED (paragraphs 20-21 and the following example) to specify the attribute to be measured, or the objective of the estimate, rather than a mechanical process to be followed or a requirement for specific documentation. Paragraph 51 of Concepts Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, notes that the application of the expected value method is subject to a cost benefit constraint depending in part on how much information is available. We are concerned, however, that some might interpret the ED as requiring a specific calculation approach and minimum documentation, for example including some minimum number of scenarios regardless of how much meaningful information is actually available. We would encourage the Board to make its intent clear.

Second, we believe the Board should reconsider the provision that would only recognize a claim liability when "the insurance enterprise expects that a claim loss will exceed the unearned premium revenue (liability) for that contract based on expected cash flows". The recognition of claim losses should be independent of revenue recognition. Once a deteriorating credit situation is identified, claim loss recognition should begin, regardless of the remaining unrecognized premium revenue. We believe that this linking of the revenue and claim loss accounting will reduce the usefulness of information about developing losses for the users of the financial statements. We also believe it is inconsistent with Statement 60, where claim loss recognition is not linked to the revenue recognition.

Practical Implementation:

We believe that the revenue recognition and balance sheet recognition provisions of the ED, if finalized, would give rise to significant implementation issues that would be best addressed before implementation. The following is a list of implementation issues that we foresee. However, this list is not intended to be all-inclusive:

- Guidance is needed for changes in installment premium cash flows, particularly with regard to when prepayments occur:
  - Should the premium receivable be adjusted through a charge-off to bad debt expense?
  - Should the unearned premium reserve liability be adjusted by recognizing amounts as earned premium?
- How does the accounting work if there is an expected loss in excess of unearned premium revenue at one date and the situation improves at a later date? Would the unearned premium revenue be reinstated?
- Deferred acquisition cost is currently established by vintage year rather than at a policy specific level. Some policies take more than one year to close. Would this standard

require policy level capitalization of costs, which is not required by Statement 60? (This would represent a change in process that would require significant systems changes at significant costs.)

- Applying a unique issuer-specific discount rate to each installment receivable estimate is impractical, will be costly to implement as it would require the determination of thousands of individual discount rates and would not appear to be beneficial to the users of the financial statements.
- Non-U.S. dollar denominated transactions will produce foreign exchange gains and losses due to the mixed measurement of the related asset and liability, i.e., the liability will be carried at a historical foreign exchange rate while asset would be revalued at the spot rate. Is that the Board's intent?
- Written premiums would need to be redefined to the extent that a financing element is to be imputed and classified as investment income.
- Further guidance with regard to reinsurance accounting is needed, specifically:
  - Are ceding commissions and premium taxes payable on installments to be based on contractual life as well?
  - Are ceding commissions and premium taxes payable to be recorded within the DAC asset account?
  - What discount rate is to be applied, the insurer's or the reinsurer's?
- The examples in the ED are simplistic, i.e., the examples do not illustrate accounting for installment premiums, the expected prepayments, or for reinsurance.

Effective Date:

As noted above, we believe a more limited standard consistent with the original objectives of this project could be reasonably completed and implemented in the time frame proposed in the ED. If the Board concludes that a more comprehensive new model is necessary, we believe that the systems and other changes required will be significant and require a lead time after final issuance of a minimum of nine months. We also would ask the Board to be mindful of the cumulative effect of new accounting pronouncements requiring implementation in any particular period (e.g., Statements 157 and 159).

Sincerely,

Sean Leonard
Chairman of the Financial Affairs Committee
Association of Financial Guaranty Insurers

EXHIBIT 1

Parity Bond Analysis (Bullet Bond)
Demonstrate difference in earning patterns when time passage is ignored for revenue recognition of FG contract

Assumptions:

Description		*Cusip*	*Par*	*Maturity*	*Yield*	*Price*	*Coupon*	*Rating*
State of California GO	**Uninsured**	13062RL71	5,000,000	3/1/2015	4.02%	106.456	5%	A1/A+
State of California GO	**Insured**	13062TDV1	5,000,000	3/1/2015	3.85%	107.644	5%	Aaa/AAA
Effective yield of $36K insurance premium collected upfront					0.08%			

		2007	2008	2009	2010	2011	2012	2013	2014	2015	Total
Interest earnings of:											
Investor in Uninsured Bond	A	$201,000	$201,000	$201,000	$201,000	$201,000	$201,000	$201,000	$201,000	$201,000	$1,809,000
Investor in Insured Bond											
Investor in Uninsured Bond		201,000	201,000	201,000	201,000	201,000	201,000	201,000	201,000	201,000	1,809,000
Less: Yield difference due to FG insurance premiums	B	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(4,000)	(36,000)
Less: Savings to Issuer	C	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)	(4,500)	(40,500)
Total for Insured Bond		192,500	192,500	192,500	192,500	192,500	192,500	192,500	192,500	192,500	1,732,500
Proposed FG Insurer earnings**	*D*	*1,241*	*1,241*	*1,241*	*1,241*	*1,241*	*1,241*	*1,241*	*1,241*	*26,069*	*36,000*
Impact of ignoring time passage	*B-D*	*(2,759)*	*(2,759)*	*(2,759)*	*(2,759)*	*(2,759)*	*(2,759)*	*(2,759)*	*(2,759)*	*22,069*	-

** Based on Exposure Draft earnings methodology

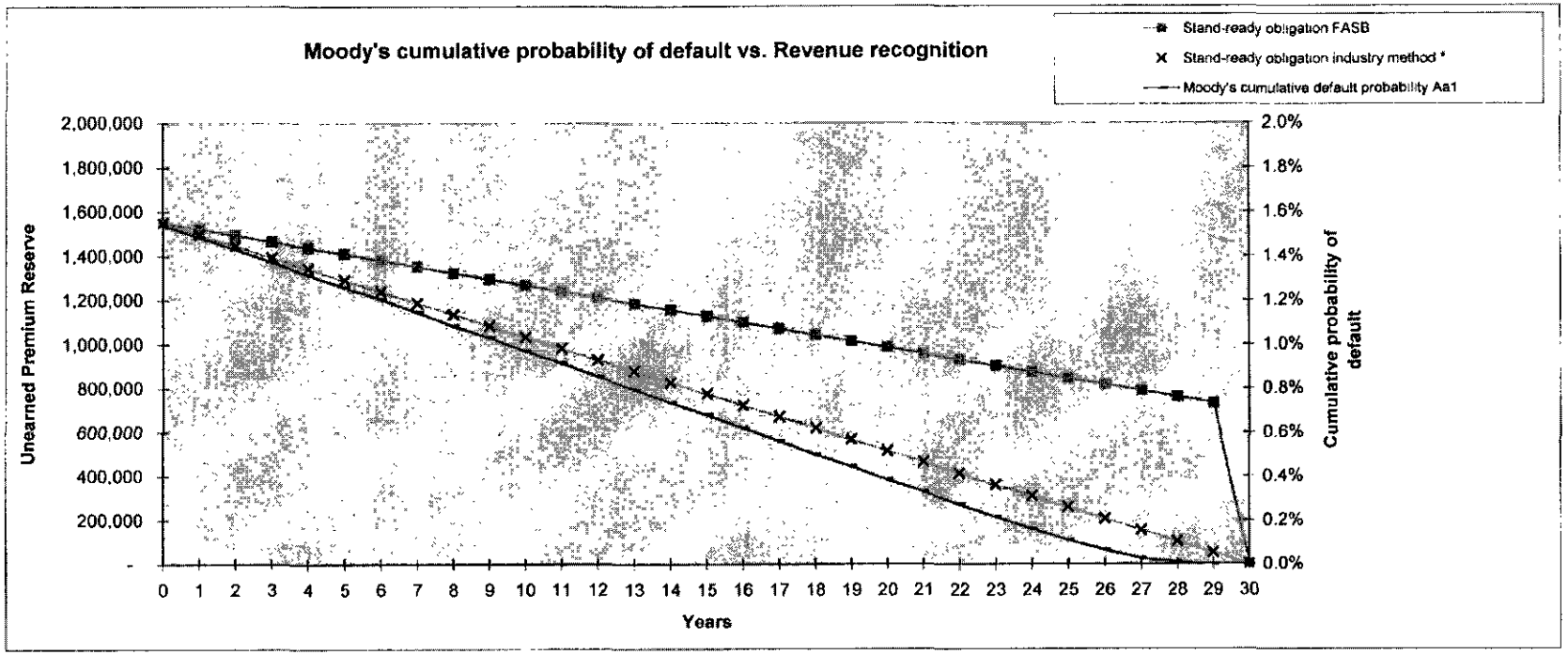
Derivation of Calculation:										
Bond cash flows (5% coupon)	250,000	250,000	250,000	250,000	250,000	250,000	250,000	250,000	5,250,000	7,250,000
Earnings rate	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	3.45%	72.41%	100.00%
Proposed FG insurer earnings	1,241	1,241	1,241	1,241	1,241	1,241	1,241	1,241	26,069	36,000

California is such a large bond issuer that there is not enough insurance capacity to insure all of their bonds. The savings that they realize incent them to insure as many of their bonds as possible. In any event they are forced to issue uninsured bonds as well as insured bonds to raise necessary proceeds. Above is a real example of a bond issued with identical terms other than that one is issued with insurance and the other is without insurance. In the above example, the uninsured form required a yield of 4.02% to clear the market while the insured form only required 3.85%. The yield difference represents the credit spread which in the insured form was partially paid to the insurer (8 bps) with the remainder (9 bps) retained by the issuer, the State of California.

The investor in the uninsured bonds will earn such credit spread of 17bps (4.02-3.85 and represented as the sum of **B+C** above) ratably over the holding period.
The insurer per the ED will be forced to defer the majority of its premium until the bond matures in 2015 (see line **D** above).
The FG is forced to ignore the economics associated with the passage of time while the bond holder, exposed to the same risk as the insurer, is permitted to recognize such economics appropriately.
The effect of ignoring time passage is reflected on the line labeled **B-D**

Exhibit 2: Aa1 Bond example

The graph below shows the Moody's cumulative probability of default curve for a municipal Aa1 bond and the unearned premium reserve (stand-ready obligation) based on the FASB methodology and industry methodology. As shown below, the industry's current methodology has a higher correlation to the Moody's probability of default curve than the FASB proposal.

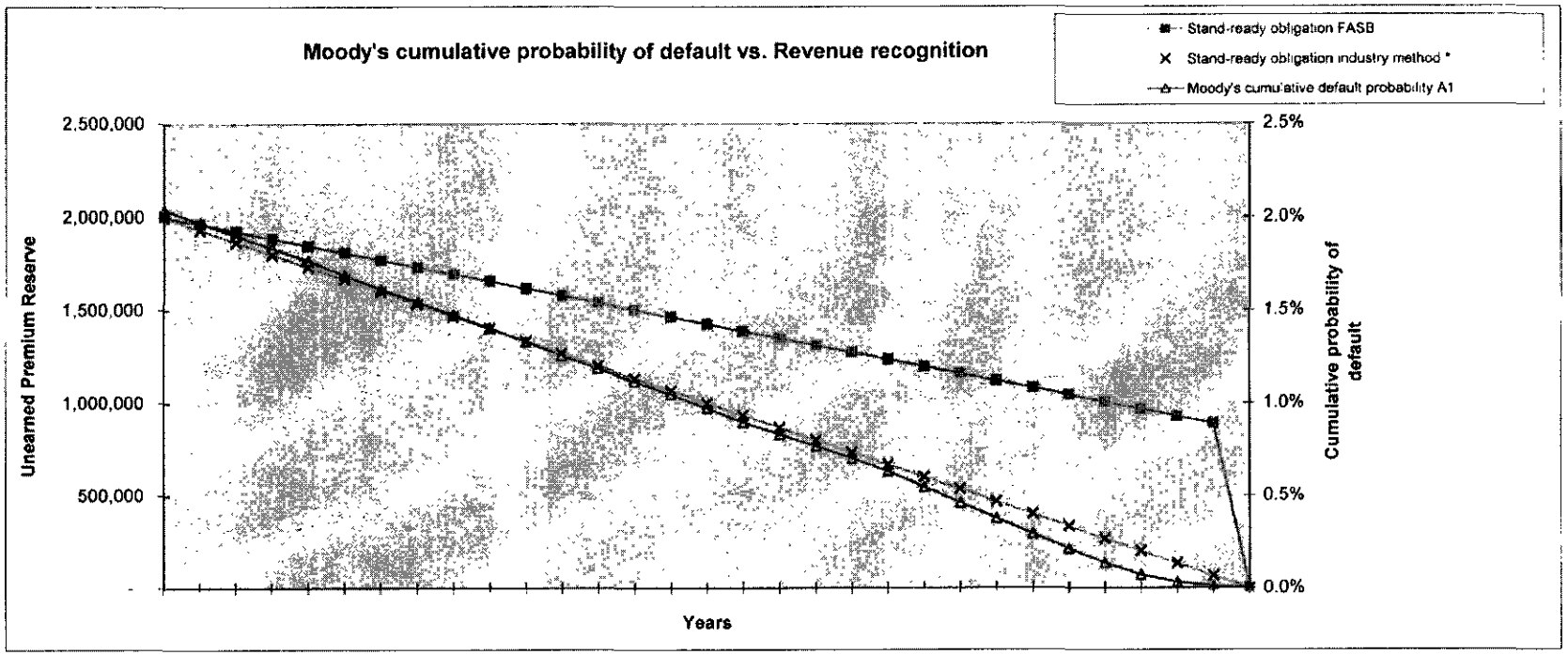


* Since this is a bond with a bullet maturity the industry method is the same as the level yield approach

Note: The Moody's cumulative probability of default curves are based on Moody's corporate default rates multiplied by the Moody's multiple for municipal bonds (currently 50%). These are the same probability of default curves used in the Moody's capital models for the financial guaranty industry.

Exhibit 2, continued: A1 Bond example

The graph below shows the Moody's cumulative probability of default curve for a municipal A1 bond and the unearned premium reserve (stand-ready obligation) based on the FASB methodology and industry methodology. As shown below, the industry's current methodology has a higher correlation to the Moody's probability of default curve than the FASB proposal.

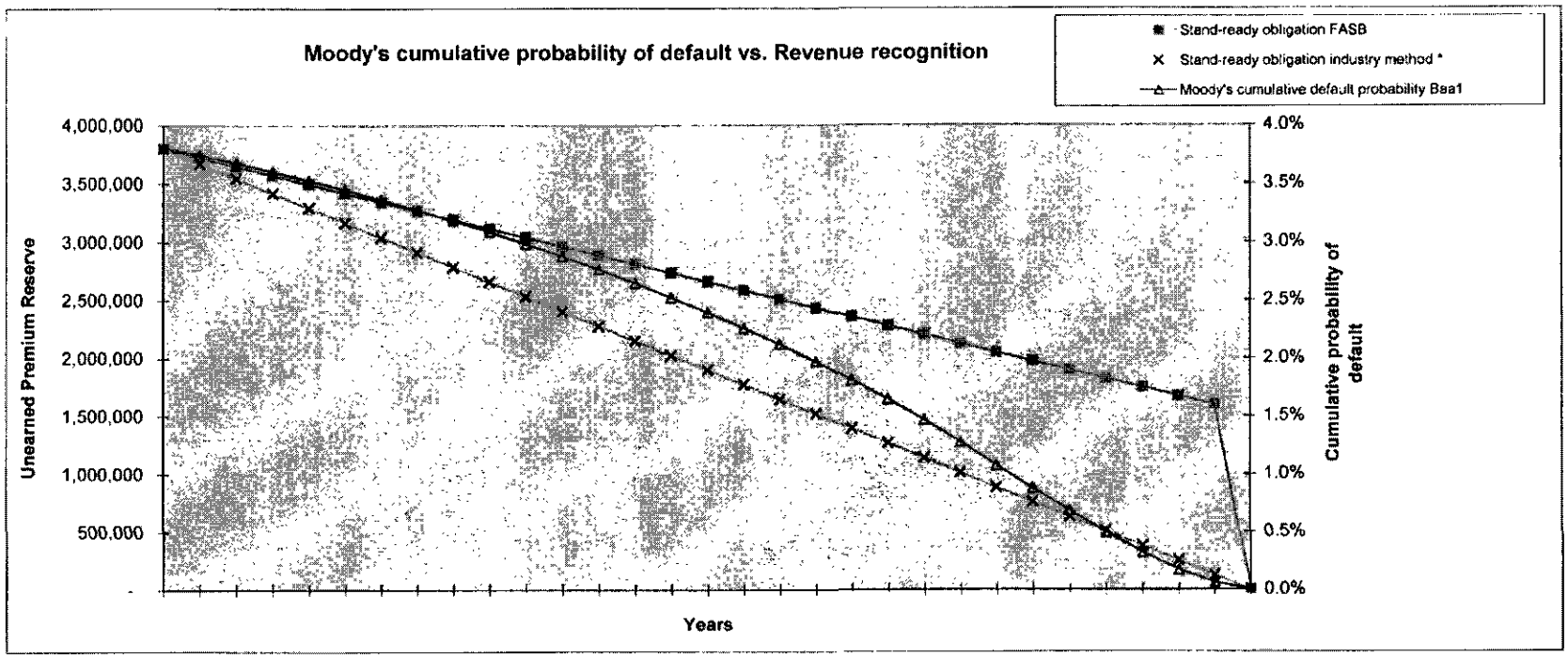


* Since this is a bond with a bullet maturity the industry method is the same as the level yield approach

Note: The Moody's cumulative probability of default curves are based on Moody's corporate default rates multiplied by the Moody's multiple for municipal bonds (currently 50%). These are the same probability of default curves used in the Moody's capital models for the financial guaranty industry.

Exhibit 2, continued: Baa1 Bond example

The graph below shows the Moody's cumulative probability of default curve for a municipal Baa1 bond and the unearned premium reserve (stand-ready obligation) based on the FASB methodology and industry methodology. As shown below, the industry's current methodology has a higher correlation to the Moody's probability of default curve than the FASB proposal.



* Since this is a bond with a bullet maturity the industry method is the same as the level yield approach

Note: The Moody's cumulative probability of default curves are based on Moody's corporate default rates multiplied by the Moody's multiple for municipal bonds (currently 50%). These are the same probability of default curves used in the Moody's capital models for the financial guaranty industry.